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**THE PERMANENT ESTABLISHMENT BASIC RULE CONCEPT UNDER THE  
MODEL TAX CONVENTIONS AND THE COLOMBIAN TAX SYSTEM:  
Analysis in light of OECD and UN model income tax conventions**

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## LIST OF ABBREVIATIONS

BEPS:	Base Erosion and Profit Shifting
CC:	Commercial Code
CTC:	Colombian Tax Code
CEPAL:	Comision Economica Para America Latina
DTT:	Double Tax Treaty
ECLAC:	Economic Commission for Latin America and the Caribbean
F1WC:	Formula One World Championship
FDI:	Foreign Direct Investment
IBFD:	International Bureau of Fiscal Documentation
ISC:	Indian Supreme Court
IFA:	International Fiscal Association
IMF:	International Monetary Fund
MNE:	Multinational Enterprises
OEEC:	Organization for European Economic Cooperation
OECD:	Organization for Economic Cooperation and Development
OECD Model:	Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development
PFA:	Pending for Approval
PE:	Permanent Establishment
SCFT:	Superior Council of Foreign Trade of Colombia
TB:	Trade or Business
UN:	United Nations
UN Model:	Model Tax Convention Between Developed and Developing Countries of the United Nations

## INTRODUCTION

Due to the phenomenon of globalization, the interdependence of countries worldwide is getting closer day by day through the increase of volume and variety of cross border transactions in goods and services and of international capital flows, and through the more rapid and widespread diffusion of technology<sup>1</sup>. This phenomenon has caused the growth of foreign investment received by countries worldwide as well as the growth of foreign companies that want to carry on their economic activities abroad.

Colombia is certainly one of the favorite countries chosen by investors, in fact, Colombia is ranked at the third place among the main recipient countries in Latin America for foreign investment, followed by Brazil<sup>2</sup>. The amount of investments in Colombia can be observed below.

<b>Foreign investment in Colombia 2007-2017<sup>3</sup></b>	
<b>Year</b>	<b>Total (Dollars)</b>
2007	5.095.883.439,60
2008	2.431.127.491,13
2009	2.264.204.599,44
2010	1.678.875.688,82
2011	2.155.321.264,13
2012	10.677.525.138,70
2013	6.455.342.407,45
2014	16.155.672.109,81
2015	7.520.513.247,86
2016	10.919.478.944,98
2017	5.930.277.650,97

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<sup>1</sup> International Monetary Fund's definition of globalization

<sup>2</sup> According to information of Governmental Office of Commerce, Industry and Tourism of Colombia

<sup>3</sup> Information based on the statistics provided by the national planning department of Colombia. See: <https://www.dnp.gov.co/programas/desarrollo-empresarial/comercio-exterior-e-inversion-extranjera/Paginas/estadisticas.aspx>

Foreign investments bring many benefits for countries, such as the increase of employments, however, the main benefit is on the rise of countries' income through the imposition of taxes on the income obtained by the non-resident companies. Accordingly, countries have been using some mechanisms in order to tax the profits of the non-residents, such as Permanent Establishment, which is used by international treaties and national laws to determine that an income obtained by a taxpayer out of its resident-territory can be taxed by another country or not<sup>4</sup>, thus, if a non-resident taxpayer carries on business through a permanent establishment situated therein, the profits of the enterprise obtained through the Permanent Establishment can be taxed in the another country (where the foreigner is).

Accordingly, knowing when a PE is constituted becomes an issue that has to be analyzed. The concept of PE differs from one country to another, however, there is a tendency among countries, such as Colombia, of following the definition of PE included in the Model Tax Convention of the OECD and UN, for this reason, the following work aims to analyze the concept of PE of the mentioned models, as well as, the definition of PE under the Colombian tax law and the relationship of each other

Nonetheless, since the concept of PE under the models is divided in a basic definition rule and special definition rules<sup>5</sup> (this distinction will be developed further), this work will focus only on the basic definition rule of PE<sup>6</sup>.

The motivation to carry out this work was born thanks to my participation in the Externado University's 2018 Iberoamerican Tax Moot Court Team. In order to solve one of the issues of the competition, I analyzed the elements of the basic rule of PE

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<sup>4</sup> Kees van Raad "Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties" in *Memorias de las 38 Jornadas Colombianas de Derecho Tributario* (2014), ICDT, pp.425

<sup>5</sup> J. Sasseville and A. A. Skaar "General Report" in, *Is there a permanent establishment?* (2009) IFA pp. 23

<sup>6</sup> Regarding the special definition rules see: Yariv Brauner "Commentary on Article 5 of the OECD Model" based on information available up to 8 June 2017. IBFD and Omar Cabrera "Permanent Establishment: Special emphasis on agency clause" (2016) Universidad Externado de Colombia

with my partner Laura Rodriguez and Maria Helena Bocachica as tutor, however, I noticed that even though the Moot Court was in 2018, our analysis of the PE concept had to be based on 2014 OECD Model instead of 2017 OECD Model, then I realized that one of the reasons why the Moot Court was not based on 2017 Model was the lack of development on it compared to the development of 2014 Model, which motivated me to do a PE concept elements research again, but this time, based on the 2017 models with the target that in the future, when other students need to carry out a similar research but based on the 2017 Models, they can use this work as a guide.

In order to reach such purpose, this work will summarize the origin and evolution of PE, then it will focus on describing each of the elements of the basic rule definition of PE in light of the OECD and UN models in order to know when a PE can be constituted, and finally, it will describe the concept of PE under the Colombian tax legal system as well as the differences and similarities with the Models and the current issues of such definition.

## **I. ORIGIN AND HISTORICAL EVOLUTION OF PE**

### **A. ORIGIN OF THE MODEL TAX CONVENTIONS**

From the beginning of the 20<sup>th</sup> century, territories have used taxes as the main mechanism to finance their needs and since the needs of each territory have been different, the taxes that must be paid therein differ from one to another. Accordingly, there have been some places where the taxes to pay are higher than others and even some places where no taxes are required to be paid.

In order to tax, countries have normally used two criteria to determine the jurisdiction to tax, these are “residence” and “source”, in the former case, the country has the right to tax its residents on their worldwide income, whereas regarding the second criterion, the country has the right to tax the income obtained therein regardless whether the person or enterprise is a resident of such state. Residence taxation of income is based on the principle that people should contribute towards the public services provided for them by the country where they live on all their income wherever it comes from, while source taxation is justified by the view that the country which provides the opportunity to generate income or profits should have the right to tax it<sup>7</sup>.

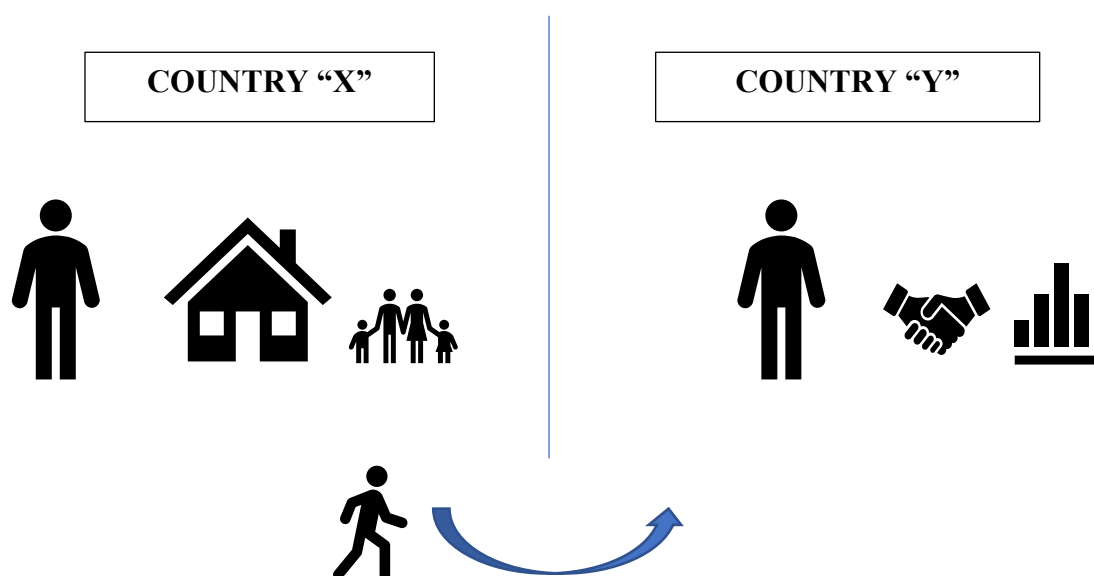
However, the last two centuries have brought, through the phenomenon called “globalization”, a significant development in the approach of economic relations between countries, breaking trade gaps and creating the same market. Nonetheless, since the economic activities of companies are increasingly international which has led to growth of multinational enterprises (MNE) for example, taxes have become a barrier that has prevented further development for this purpose, because countries, by applying the criteria mentioned above, could tax twice a person over the same

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<sup>7</sup>Tax Justice Network “Source and Residence Taxation” which is a Briefing based on a manuscript prepared by Reuven Avi-Yonah (University of Michigan) available at [https://www.taxjustice.net/cms/upload/pdf/Source\\_and\\_residence\\_taxation\\_-\\_SEP-2005.pdf](https://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf)



income which causes a double taxation<sup>8</sup>. For instance, “A” is a resident of a country “X” which has a tax income rate of 50% and “A” generates COP 1.000 from an activity done within “Y” which has a tax income rate of 40%, thus, the country “Y” will tax the income (because it is the source country) at 40% which means that “A” will have to pay COP 400 but also the country “X” will tax the income (because it is the residence country) at 50% which means that “A” will have to pay COP 500, as a result “A” will be left with COP 100 (1.000-400-500). This obviously represents a huge problem for the enterprisers which are discouraged from realizing investments at the international level.



As a mechanism to tackle this situation of double taxation from happening and to encourage international investment flows, some countries decided unilaterally to include some rules in their domestic regulations that limit their taxing rights<sup>9</sup>. Likewise, countries began to conclude agreements in order to distribute the rights to tax by establishing when and how a country could tax an income. The first modern

<sup>8</sup> There are two types of double taxation, the first one is Juridical Double Taxation that happens when a same person (individual or entity) is taxed in respect of same object by two authorities and the second is Economic Double Taxation that occurs when a same income is taxed twice to different persons, for instance when a company does not itself spend its profits but transfers them to its shareholders as dividends.

<sup>9</sup> For the purpose of this thesis, only permanent establishment avoiding double tax mechanism will be analyzed.

double tax treaty DTT was signed by Austro-Hungarian Empire and Prussia on 21<sup>st</sup> of June 1899<sup>10</sup>. Since then, the number of treaties has been rising steadily; at the beginning, mostly industrialized countries entered into such treaties with each other and as result, nowadays there are about 2.600 double tax treaties worldwide<sup>11</sup>.

However, although DTTs were originally signed to avoid double taxation, i.e. the taxation of the same underlying transaction by two governments, these days, reasons are more manifold, and include the mitigation of international tax avoidance and evasion<sup>12</sup> and thus, the protection of the domestic tax base<sup>13</sup>.

## **B. HISTORICAL EVOLUTION OF PE CONCEPT**

The DTT signed by Austria-Hungary and Prussia contained a general definition of business establishment<sup>14</sup> which provided a list of examples:

“...branch establishments, factories, depots, offices, places where purchases and sales are effected and other facilities by which the owner, partner, manager, or other permanent representative carries on his normal business activities”

It is important to note the divergence in the title employed<sup>15</sup> because, as it can be observed, such treaty used the expression “business establishment”, however, the doctrine agrees to understand it as PE.

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<sup>10</sup> A. Easson “Do We Still Need Tax Treaties?” (2000). World Tax Journal IBFD pp. 619-625

<sup>11</sup> IBFD Tax Research Platform, available at <http://www.ibfd.org>

<sup>12</sup> With this regard, the OECD made BEPS Project which involves 15 actions to equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created. The action regarding PE issues is action 7, which was included in the latest OECD Model See: <http://www.oecd.org/tax/beps/beps-actions.htm>

<sup>13</sup> Julia Braun and Martin Zagler “An Economic Perspective on Double Tax Treaties with(in) Developing Countries” (2014) World Tax Journal IBFD pp 4

<sup>14</sup> The PE clause incorporated within Austria-Hungary and Prussia treaty was originally developed under domestic German law to ensure efficient allocation of tax bases among Prussian municipalities and later among German states. See: Yariv Brauner “Commentary on Article 5 of the OECD Model” based on information available up to 8 June 2017. IBFD pp 3

<sup>15</sup> Benjamin Walker “The evolution of the Agency Permanent Establishment Concept” available at <https://www.business.unsw.edu.au/About-Site/Schools-Site/Taxation-Business-Law-Site/Documents/40-Walker-ATTA2018.pdf> pp 3

Some time later, The League of Nations, which was created in 1919 in order to guarantee peace and stability to avoid the catastrophe of World War One<sup>16</sup>, established a group of experts called "Group of Economists" to settle (among other activities) a basis for the principles of international tax jurisdiction<sup>17</sup>. The group made different reports, but it was not until the report delivered in 1925 that the first attempt to define PE was incorporated. Such report held that to avoid double taxation on income from business benefits obtained by a resident of a Contracting State in the other State<sup>18</sup>, the State in which the source of income is situated is entitled to impose impersonal or scheduler taxes<sup>19</sup> in portion of the net income produced by "a branch, agency, an establishment, a stable commercial or industrial organization, or a permanent representative" in their territory<sup>20</sup>. Despite the importance of this report in the development of PE, it simply made a list of PEs<sup>21</sup> without providing a definition of it.

The same pattern of including a list of PEs, instead of making a definition of it, is repeated in the following reports of the Committee of Technical Experts, for instance, in article 5(2) of the Double Taxation and Tax Evasion Committee of Technical Experts report of 1927 it was set that PE involved:

"The real centers of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent, etc.), shall not be held to

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<sup>16</sup> See: Clavin, *Securing the World Economy: The Reinvention of the League of Nations*, (Oxford University Press, 2013)

<sup>17</sup> Benjamin Walker "The evolution of the Agency Permanent Establishment Concept" Op. Cit., pp 4

<sup>18</sup> Omar Cabrera "Permanent Establishment: Special emphasis on agency clause" (2016) Universidad Externado de Colombia pp 63

<sup>19</sup> League of Nations: Technical Experts to the Economic and Financial Committee Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee Document F.212 Geneva, February 1925.

<sup>20</sup> Benjamin Walker "The evolution of the Agency Permanent Establishment Concept" Op. Cit., pp 5

<sup>21</sup> Ibid.

mean that the undertaking in question has a permanent establishment in that country.”<sup>22</sup>

Although there were gradually included or modified elements into what PE involved, this period was characterized by not having an actual definition of PE.

After the end of the wars, because of the political and economic stability worldwide, the countries began to take an increased interest in the problem of double taxation due to the concern in promoting the flow of investment<sup>23</sup>. That is why in the 1950s, after the League of Nations was dissolved, the leadership<sup>24</sup> of the universal tax treaties projects passed to the OEEC (in 1961 the name is changed into OECD)<sup>25</sup> which created a fiscal committee which began an arduous task to carry out a draft treaty to avoid double taxation that could meet the needs of developed countries. After 6 reports<sup>26</sup>, the fiscal committee elaborated *the 1963 the OECD Draft Convention for the avoidance of double taxation respect to taxes on Estates and Inheritances* which incorporated in its article 6(2)<sup>27</sup> a definition of PE:

“The term “permanent establishment” means a fixed place of business in which the business of the deceased was wholly or partly carried out”.

This Model was followed by a new version in 1977 that included a few changes<sup>28</sup>, which has remained so during the different versions of the model until its latest

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<sup>22</sup> League of Nations, Double Taxation and Tax Evasion, Committee of Technical Experts art. 5(2) (1927)

<sup>23</sup> Radhakishan Rawal and Sanjay Kumar “Commentary on the Permanent Establishment Concept under the UN Model Tax Convention” based on information available up to 1 March 2018. IBFD pp2

<sup>24</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” based on information available up to 8 June 2017. IBFD pp 3

<sup>25</sup> The Organization for Economic Cooperation and Development (OECD) is a unique forum where the governments of 34 democracies with market economies work with each other, as well as with more than 70 non-member economies to promote economic growth, prosperity, and sustainable development. The Organization provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies. See: <https://usoecd.usmission.gov/our-relationship/about-the-oecd/what-is-the-oecd/>

<sup>26</sup> Available at <http://taxtreatieshistory.org>

<sup>27</sup> Some authors say that the definition of PE was incorporated from the beginning in article 5, but according to 1963 Draft, which can be consulted at <http://taxtreatieshistory.org>, at first, the definition of PE was incorporated within Article 6 (2).

<sup>28</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp 3

version corresponding to 2017, however, its commentaries<sup>29</sup> have been constantly changing.<sup>30</sup>

Because the model created by the OECD mainly favored the interests of developed countries and affected developing countries interests, the United Nations UN<sup>31</sup> through its general secretary, set up in 1968 the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries<sup>32</sup> in order to make another Model that could take into account Developing countries' needs and as a result the UN published the United Nations Model Double Taxation Convention in 1980. Regarding PE basic concept, UN Model basically followed OECD Model with some changes.

### **C. CURRENT PE PROVISIO IN THE DTTS**

Nowadays, the models of UN and OECD are the most used worldwide by countries wishing to enter into bilateral tax treaty negotiations, these treaties have significant common provisions. The similarities between these two leading Models reflect the importance of achieving consistency where possible. On the other hand, the important areas of divergence exemplify some key differences in approach or emphasis between developed countries and developing countries. Such differences relate, in particular, to the issue of how far one country or the other should give up on their taxing rights, under a bilateral tax treaty, taxing rights which would be

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<sup>29</sup> For each Article in the Models, there is a detailed Commentary that is intended to illustrate or interpret its provisions. As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes. The tax administrations of member countries routinely consult the Commentaries in their interpretation of bilateral tax treaties. The Commentaries are useful both in deciding day-to-day questions of detail and in resolving larger issues involving the policies and purposes behind various provisions. Tax officials give great weight to the guidance contained in the Commentaries See: Model Tax Convention on Income and on Capital of the OECD Model condensed version.

<sup>30</sup> Omar Cabrera "Permanent Establishment: Special emphasis on agency clause" Op. Cit., pp 79

<sup>31</sup> In the mid-1960s the number of the developing countries members of United Nations increased enhancing the importance of the institution

<sup>32</sup> Radhakishan Rawal and Sanjay Kumar "Commentary on the Permanent Establishment Concept under the UN Model Tax Convention" Op. Cit., pp 2

available to it under domestic law, with a view to avoiding double taxation and encouraging investment.<sup>33</sup>

One of those common provisions is the basic rule which has the same wording. This basic rule is incorporated within article 5 (1)<sup>34</sup>, however, in order to have a proper contextualization of the basic rule, it has to be analyzed with article 5(4)<sup>35</sup> which establishes a list of exclusions to the basic rule, therefore, such article must be considered part of the basic rule. Regarding the exclusions to the basic rule there are some discrepancies between the models.

The current concept (basic rule) of PE incorporated in each of the models as well as their differences are reproduced hereunder:

OECD MODEL 2017	UN MODEL 2017
<p>1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.</p> <p>4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:</p> <p>a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;</p> <p>b) the maintenance of a stock of goods or merchandise belonging to the enterprise</p>	<p>1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.</p> <p>4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:</p> <p>a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;</p>

<sup>33</sup> Extract taken from UN official Commentary origin of the united nations model convention

<sup>34</sup> Radhakishan Rawal and Sanjay Kumar “Commentary on the Permanent Establishment Concept under the UN Model Tax Convention” Op. Cit., pp 4

<sup>35</sup> Omar Cabrera “Permanent Establishment: Special emphasis on agency clause” Op. Cit., pp 101

<p>solely for the purpose of storage, display or delivery;</p> <p>c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</p> <p>d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;</p> <p>e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity</p> <p>f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.</p> <p>4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and</p> <p>a) that place or other place constitutes a permanent establishment for the enterprise</p>	<p>(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;</p> <p>(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;</p> <p>(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;</p> <p>(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity.</p> <p>(f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.</p> <p>4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and</p> <p>a) that place or other place constitutes a permanent establishment for the enterprise or</p>
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<p>or the closely related enterprise under the provisions of this Article, or</p> <p>b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.</p>	<p>the closely related enterprise under the provisions of this Article, or</p> <p>b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.</p>
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Although some differences between the models regarding the exclusions incorporated in article 5(4) such as that a delivery might result in a PE under the UN Model, without doing so under the OECD Model<sup>36</sup>, they both define the term “permanent establishment” as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

A PE can also be constituted through a dependent agent acting on behalf of the enterprise and habitually exercising an authority to conclude contracts in the name of the enterprise<sup>37</sup>, however, as it mentioned previously, this analysis is focus on the basic rule.

<sup>36</sup> Radhakishan Rawal and Sanjay Kumar “Commentary on the Permanent Establishment Concept under the UN Model Tax Convention” Op. Cit., pp 4

<sup>37</sup> See: Omar Cabrera “Permanent Establishment: Special emphasis on agency clause” (2016) Universidad Externado de Colombia and Sidney I. Roberts “The agency element of permanent establishment: The OECD Commentaries from the civil law view” (2008) IBFD.



## II. ELEMENTS AND APPLICATION OF THE BASIC RULE OF PERMANENT ESTABLISHMENT CONCEPT UNDER THE OECD AND UN MODEL INCOME TAX CONVENTIONS

According to the definition provided by article 5 (1) of the DTTs, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. According to this definition, for the constitution of a PE in principle, the following elements have to be met: 1. The existence of a fixed place of business; 2. This place of business must be fixed; and 3. The business of the enterprise must be carried on through the fixed place of business.

However, the OECD and UN have developed commentaries<sup>38</sup> which explain in more detail how the wording of the permanent establishment definition, incorporated within the DTTs, should be interpreted<sup>39</sup>, as well as some specialized authors<sup>40</sup>. As a result, there is an agreement that the following elements or conditions<sup>41</sup> are required to be met in order to have a PE under the article 5(1) of the DTTs:

- “PLACE OF BUSINESS” ELEMENT: The non-resident taxpayer must have a place of business in the source state.
- “FIXED” ELEMENT: Such place of business must be fixed.
- “AT THE DISPOSAL OF” ELEMENT: The place of business must be at the disposal of the non-resident taxpayer.

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<sup>38</sup> For the Commentaries to the OECD Model Convention on Income and Capital is used the following abbreviations: Commentary (Comm.). Article (Art.). If reference is made to another version of the Commentary than the 2017 version, this will be indicated by inserting the date of the version to which reference is made in front of the word “Comm.”). For the Commentaries of the UN Model Convention is used the following abbreviations: Commentary (Comm-UN.). Article (Art.). If reference is made to another version of the Commentary than the 2017 version, this will be indicated by inserting the date of the version to which reference is made in front of the word “Comm-UN.”).

<sup>39</sup> J. Sasseville and A. A. Skaar “General Report” in, Is there a permanent establishment? (2009) IFA pp 6

<sup>40</sup> Such as Arvid A. Skaar, Yariv Brauner and Kees van Raad

<sup>41</sup> See: Jacques Sasseville and Arvid A. Skaar “General Report” in, Is there a permanent establishment? (2009) IFA and Comm. on Art. 5, paragraph 3

- “BUSINESS ACTIVITY” ELEMENT: The non-resident taxpayer must carry a business activity that is considered as such under the treaty.
- “BUSINESS CONNECTION” ELEMENT: The business activity must be conducted through the place of business.

Although it is agreed that these are the elements that constitute the concept of PE, there is a divergence in the way each of these elements must be interpreted, which causes that while some jurisdictions consider that the elements are met, others do not. Accordingly, each of these elements will be analyzed in the way they have been developed by the commentaries of the OECD-UN and the doctrine, as well as, in the way they have been applied in some cases worldwide.

#### **A. “PLACE OF BUSINESS” ELEMENT.**

##### **i. PHYSICAL PRESENCE**

Neither the Model nor the commentaries define the term “place of business”<sup>42</sup>, nonetheless, the commentary<sup>43</sup> says that such term covers any physical location, premises, facilities or installations used to carry on the business of the enterprise regardless those places are used exclusively for that purpose. Such commentary has entailed a commonly accepted understanding that a place of business is the physical presence of the non-resident taxpayer in the source country. Thus, a website, a letter-box, a mailing address, an address used for transmitting mail to the recipient (so on) cannot constitute a place of business<sup>44</sup>.

Further, the commentaries hold that any particular amount of space may be a place of business, in this regard, even a desk or a filing cabinet in the corner of a private residence<sup>45</sup> could fit into this understanding. In fact, any physical space that may be used to carry on the business is suitable to be a place of business<sup>46</sup>, regardless

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<sup>42</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp 6

<sup>43</sup> Comm. on Art. 5, paragraph 10

<sup>44</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, Is there a permanent establishment? Op. Cit., pp. 23

<sup>45</sup> Ibid pp. 24

<sup>46</sup> C. Finnerty et al., “Fundamentals of International Tax Planning” (2007), IBFD, pp.40

whether the place is located within the business facilities of another person's enterprise<sup>47</sup> or whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise<sup>48</sup>. The commentary<sup>49</sup> goes even further regarding the low threshold of this requirement, stating that "a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business". Altogether, it is clear that the way "place of business element" has been understood so far means that the physical presence is crucial, and so is its factual, rather than a mere legal connection to the taxpayer.<sup>50</sup>

Moreover, the object of the taxpayer's business can also constitute a place of business, as it can be observed in the examples provided by the commentary<sup>51</sup>

"...a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitutes a permanent establishment of that painter".

For that painter, the building is therefore both a place of business and the object of the business<sup>52</sup>.

In contrast to the general scope provided by the Models and the commentaries regarding the term place of business<sup>53</sup>, article 5(2) incorporates a list<sup>54</sup> of physical places that automatically trigger a place of business. These are:

- A place of management

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<sup>47</sup> Kees van Raad "Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties" in *Memorias de las 38 Jornadas Colombianas de Derecho Tributario* (2014), ICDT, pp. 427

<sup>48</sup> Comm. on Art. 5, paragraph 10

<sup>49</sup> Comm. on Art. 5, paragraph 11

<sup>50</sup> Yariv Brauner "Commentary on Article 5 of the OECD Model" Op. Cit., pp.11

<sup>51</sup> Comm. on Art. 5, paragraph 17

<sup>52</sup> Jacques Sasseville and Arvid A. Skaar "General Report" in, *Is there a permanent establishment?* Op. Cit., pp. 25

<sup>53</sup> Yariv Brauner "Commentary on Article 5 of the OECD Model" Op. Cit., pp.11

<sup>54</sup> The doctrine has called it "the positive list" to differentiate it from "the negative list" incorporated in article 5 (4)

- A branch
- An office
- A factory
- A workshop
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

## ii. **ECONOMIC PRESENCE**

However, the fact that existing thresholds for taxation rely on physical presence, does not heed the current reality of economic worldwide because the evolution of business models in general, and the growth of the digital economy in particular, have resulted in non-resident companies operating in a market jurisdiction in a fundamentally different manner today than at the time international tax rules were designed. For example, although a non-resident company has always been able to sell into a jurisdiction without a physical presence there, nowadays the advances in information and communication technology (ICT) have dramatically expanded the scale at which such activities are now possible<sup>55</sup>. As a result, day by day, less physical presence is required in market economies in typical business structures, which makes the current requirement of having a physical presence in the source country, an obsolete criterion<sup>56</sup>.

In this regard, the OECD decided to address the tax challenges of the digital economy through the action number 1<sup>57</sup> of the BEPS Action plan. In the final report of such action, the OECD identified:

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<sup>55</sup> OECD, BEPS Action 1 Final Report (2015), pp. 98

<sup>56</sup> D.W. Blum, Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined? (2015) Journals IBFD, pp. 6-7

<sup>57</sup> This action discusses the background leading to the adoption of the BEPS Action Plan, including the work to address the tax challenges of the digital economy, the work of the Task Force on the Digital Economy leading to the production of the report. It also provides some conclusions reached with respect to the business models and key features of the digital economy. See: <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1539036478&id=id&accname=guest&checksum=A4F2E103DAD087C835566027B850C215>

“In general terms, in the area of direct taxation, the main policy challenges raised by the digital economy fall into three broad categories:

- **Nexus:** The continual increase in the potential of digital technologies and the reduced need in many cases for extensive physical presence in order to carry on business, combined with the increasing role of network effects generated by customer interactions, can raise questions as to whether the current rules to determine nexus with a jurisdiction for tax purposes are appropriate.
- **Data:** The growth in sophistication of information technologies has permitted companies in the digital economy to gather and use information across borders to an unprecedented degree. This raises the issues of how to attribute value created from the generation of data through digital products and services, and of how to characterize for tax purposes a person or entity’s supply of data in a transaction, for example, as a free supply of a good, as a barter transaction, or some other way.
- **Characterization:** The development of new digital products or means of delivering services creates uncertainties in relation to the proper characterization of payments made in the context of new business models, particularly in relation to cloud computing”.

As a result, the report holds that it is necessary to redefine the current nexus criteria for taxation in the source country. For that purpose, it says that the concept of PE should be based on “significant economic presence<sup>58</sup>” rather than physical presence. Thus, a non-resident taxpayer would be taxable in the source country where the taxpayer establishes or realizes a significant economic presence<sup>59</sup>.

In order to measure whether the economic presence of a non-resident is significant in the economic life of a country, the action 1 provides various alternative tests/factors that states are free to adopt in their domestic law if they wish to take

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<sup>58</sup> OECD, BEPS Action 1 Final Report (2015), pp. 107

<sup>59</sup> Vishesh Dhuldhoya “The future of the permanent establishment concept” (2018) IBFD, pp. 15

further steps in the context of taking profits arising from activities in the digital economy<sup>60</sup>. These factors are:

- Revenue factor: it is based on the revenues generated from digital transitions within a country by a non-resident company<sup>61</sup>. This is a potential factor for establishing nexus in the form of a significant economic presence in the country concerned. However, an accurate application of the revenue threshold would depend on the ability of the country to identify and measure remote sales activities of the non-resident enterprise. One possible approach to address this challenge could be to introduce a mandatory registration system for enterprises.<sup>62</sup>
- Digital factor: According to this factor, there is a strong nexus between a non-resident company and a country where the interaction of the company with users or customers is sustained. This factor considers whether the non-resident company has a local domain name, for instance “.co”, or whether the non-resident company has a local digital platform or a local digital option.
- User-based factor: According to this, the number of contracts concluded digitally with the customers who are resident in the source country or the volume of data<sup>63</sup>, could be used to reflect the level of participation in the economic life of such country.

The action 1 holds that an economic presence always needs to fulfill the revenue factor in order to be significant because it is the primary factor, however, it is not sufficient in isolation to establish the nexus, but it could be combined with other factors and potentially be used to establish nexus in the form of a significant economic presence in the country concerned<sup>64</sup>.

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<sup>60</sup> Ibid pp. 7

<sup>61</sup> Ibid pp. 15

<sup>62</sup> OECD, BEPS Action 1 Final Report (2015), pp. 108

<sup>63</sup> Vishesh Dhuldhoya “The future of the permanent establishment concept” Op. Cit., pp. 15

<sup>64</sup> OECD, BEPS Action 1 Final Report (2015), pp. 107

As a conclusion, this new view of the place of business element based on significant economic presence rather than physical presence will be the current reality of economies worldwide and allow countries to tax non-resident companies operating through digital economic activities. However, this concept of economic presence is yet a nascent stage and needs further analysis and development as recommended by the OECD<sup>65</sup>.

## **B. “FIXED” ELEMENT**

According to the commentary<sup>66</sup>, the place of business must be fixed to be considered as a PE. The term ‘fixed’ is related to two perspectives<sup>67</sup>: 1. The place of business must be fixed in terms of location 2. The place of business must be fixed in terms of time. For each of these perspectives, there is a test which must be met in order to consider a place of business as fixed. These tests are “Locus test” and “Tempus test”<sup>68</sup>.

### **i. LOCUS TEST**

According to the commentary<sup>69</sup>, there has to be a link between the place of business and a specific geographical point. The most direct interpretation of the fixed locus test would be that the place of business must be connected to the soil<sup>70</sup> or located at a specific continual geographical place within the taxing jurisdiction of the candidate PE state<sup>71</sup>. Nonetheless, the commentary<sup>72</sup> holds that the equipment

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<sup>65</sup> Vishesh Dhuldhoya “The future of the permanent establishment concept” Op. Cit., pp. 15

<sup>66</sup> Comm. on Art. 5, paragraph 5

<sup>67</sup> Kees van Raad “Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties” Op. Cit., pp. 427

<sup>68</sup> The names of the tests were taken from Casper Barbier “The Permanent Establishment in a post BEPS world” (2016), Tilburg University, pp.35. However, it does not mean that all authors name them in the same way, for instance, Sasseville and Arvid A. Skaar in “General Report” in, Is there a permanent establishment? (2009) IFA pp.17 name them as “The location test” and “The duration test”, nonetheless, the content is the same regardless how they are called.

<sup>69</sup> Comm. on Art. 5, paragraph 21

<sup>70</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp.14

<sup>71</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, Is there a permanent establishment? Op. Cit., pp. 25

<sup>72</sup> Comm. on Art. 5, paragraph 21

constituting the place of business does not need to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site.

In this regard, it is clear that undergrounds, pipelines, railroads, mines etc., meet the requirement under the locus test for a PE<sup>73</sup>. By contrast, ships or aircrafts that navigate in international waters or within one or more States do not meet the requirement under the locus test and do not, therefore, constitute a fixed place of business<sup>74</sup>.

However, it is not clear whether the locus test is met when the nature of the business activities, carried on by an enterprise, is such, that these activities are often moved between neighboring locations<sup>75</sup>. Based on that reasoning, the Commentary<sup>76</sup> and specialized authors have developed, accordingly, a requirement of geographical and commercial coherence regarding the place concerned<sup>77</sup> by saying that if a non-resident taxpayer is moving around within a geographically coherent area and performing a commercially coherent business activity for clients therein, such area may meet the locus test.

Although there is no definition of coherent geographical area or commercial coherence, the commentaries incorporate some examples which illustrate the way they work.

Concerning the coherent geographical area, paragraph 23 of the commentaries on article 5 of the OECD Model which also applies for UN Model, says:

“A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an “office hotel” in which a consulting firm regularly rents different

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<sup>73</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, *Is there a permanent establishment?* Op. Cit., pp. 26

<sup>74</sup> Comm. on Art. 5, paragraph 26

<sup>75</sup> Ibid paragraph 22

<sup>76</sup> Comm. on Art. 5, paragraphs 22, 23, 24 and 25

<sup>77</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp. 14



offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader”.

From these examples, it can be understood that there is a coherent geographical area when the place where the non-resident taxpayer performs his business activities can be distinguished as a single place.

On the other hand, with respect to commercial coherence, the paragraph 24 of the commentaries on article 5 of the OECD Model which also applies for UN Model, distinguishes, through the same example, when there is or not commercial coherent:

“... where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically”.

This example shows that the key to having a commercial coherence is the presence of one single business from the client’s perspective<sup>78</sup>.

## **ii. TEMPUS TEST**

As it is derived from the word “Permanent”, a PE can be deemed to exist only if the place of business has a certain degree of permanency<sup>79</sup>. However, no rule establishes how long a place of business must stay to be considered permanent. In this regard, the commentary interprets that the experience has shown that

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<sup>78</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp. 15

<sup>79</sup> Comm. on Art. 5, paragraph 28

permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months<sup>80</sup>; some authors have called the six months term as “Rule of thumb”<sup>81</sup>.

However, this shall not be considered as a rule, because it only shows a pattern between country practices and the time frame of six months does not consider different businesses models<sup>82</sup>.

The commentary<sup>83</sup> shows two events (the commentary calls it “exceptions”<sup>84</sup>) when a place of business may constitute a permanent establishment even though it exists, in practice, only for a brief period because the nature of the business is such that it will only be carried on for that short period of time.

The first exception applies for those cases of activities of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used<sup>85</sup>. To illustrate it, the commentary<sup>86</sup> provides an example:

“An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for five years. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any continuous presence lasts less than six months; the time requirement could similarly

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<sup>80</sup> Ibid

<sup>81</sup> C. Finnerty et al., “Fundamentals of International Tax Planning” Op. Cit., pp. 40

<sup>82</sup> Casper Barbier “The Permanent Establishment in a post BEPS world” (2016) Tilburg University p.35

<sup>83</sup> Comm. on Art. 5, paragraph 28

<sup>84</sup> Although I consider the commentaries should not have called them “exceptions” because it makes think that the six months term pattern is a rule, I use such expression in order to make cohesion between the text and the commentaries.

<sup>85</sup> Comm. on Art. 5, paragraph 29

<sup>86</sup> Ibid

be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business”.

In this regard, the court of Austria held in a case<sup>87</sup> that for those activities that can only be performance during certain short time of the year, such as summer, the rule of 6 months cannot be applied in view of the fact that the taxpayer company’s main yearly activity is limited to such period.

With respect to the second exception, when the non-resident carries on a business exclusively and wholly within the source country through a place of business, even if the business is of a short duration because its nature, such place of business may constitute a PE. As the first exception, the commentary<sup>88</sup> provides an example<sup>89</sup> to make it more understandable:

“An individual resident of State R has learned that a television documentary will be shot in a remote village in State S where her parents still own a large house. The documentary will require the presence of a number of actors and technicians in that village during a period of four months. The individual contractually agrees with the producer of the documentary to provide catering services to the actors and technicians during the four-month period and, pursuant to that contract, she uses the house of her parents as a cafeteria that she operates as sole proprietor during that period. These are the only business activities that she has carried on and the enterprise is terminated after that period; the cafeteria will therefore be the only location where the business of that enterprise will be wholly carried on. In that case, it could be considered that the time requirement for a permanent establishment is met since the restaurant is operated during the whole existence of that particular business. This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four-month production of a documentary. In that case, the

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<sup>87</sup> Austria - Case 2000/15/0118, 18 March 2004

<sup>88</sup> Ibid paragraph 30

<sup>89</sup> These examples were introduced in the 2017 OECD Model due to the to the confusion of readers. Thus, the previous model such as 2014, did not incorporated these examples.

company's business, which is permanently carried on in State R, is only temporarily carried on in State S.”

Accordingly, the Indian Supreme Court ISC<sup>90</sup> considered that even though the taxpayer's access to the Indian company's premises was limited to up-to six weeks at a time during the Formula One World Championship F1WC season, it is satisfied the tempus test for the existence of a fixed place because the very nature of the activities in question was of a short duration and one which had a “shifting or moving presence”. According to the ISC, the fact that non-resident taxpayer had control for the entire duration of the event and that the contract lasted five years, which meant that there was repetition, was sufficient to satisfy the tempus test for the existence of a PE<sup>91</sup>.

Notwithstanding these cases and the clarifications within the commentaries, when it comes to the application of the models, there are sporadic cases in which a place of business is considered to meet the requirement of being fixed when a non-resident taxpayer carries on business therein for a period shorter than 6 months.

### **C. “AT THE DISPOSAL OF” ELEMENT**

According to the commentary<sup>92</sup> the term “place of business” covers any physical location, premises, facilities or installations used to carry on the business of the enterprise whether or not they are used exclusively for that purpose. Then, the commentary<sup>93</sup> includes a requirement that the place of business (the space) must be “at the disposal” of the enterprise, thus, even though it is not expressly mentioned in Art. 5, for a PE to exist, the space where the activity is carried out must be at the disposal of the entrepreneur<sup>94</sup>.

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<sup>90</sup> India - Formula One World Championship Ltd. v. CIT, 24 April 2017

<sup>91</sup> Vishesh Dhuldhoya “The future of the permanent establishment concept” Op. Cit., pp. 8

<sup>92</sup> Comm. on Art. 5, paragraph 10

<sup>93</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp. 5

<sup>94</sup> Kees van Raad “Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties” Op. Cit., pp. 429.

Additionally, the commentary<sup>95</sup> adds that the mere presence of an enterprise at a particular location does not necessarily mean that the location is at the disposal of that enterprise. The expression “at its disposal” means that the enterprise has a space which is “lockable”, implying that it has the effective power to use that location.

There must be a space placed with the right of access and use of the enterprise or controlled by it<sup>96</sup>; such right to access and use of the place of business is not required to be a legal right<sup>97</sup>. Therefore, a permanent establishment could even exist when an enterprise illegally occupied a certain location where it carried on its business<sup>98</sup> as long as the enterprise has the effective power to use that location. Although in the view of some countries, like Germany, the non-resident taxpayer needs to have some sort of legal right to dispose of the place<sup>99</sup>, there is a general consensus that no formal legal right is required<sup>100</sup>. Nonetheless, when an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities because it has legal possession of that location (legal right), that location is clearly at the disposal of the enterprise<sup>101</sup>.

In order to consider that an enterprise has the right to access and use of a certain place, the enterprise needs to have the right not to be denied the use of the place of business<sup>102</sup>. Therefore, if the enterprise can be denied of the use of the place, it cannot be considered that the place where the activity is carried out is at its disposal. In this regard, the German Federal Fiscal Court<sup>103</sup> held in a case that:

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<sup>95</sup> Comm. on Art. 5, paragraph 12

<sup>96</sup> Taxsutra “Indian Authority for Advance Ruling Upholds PE for Belgian Company; Lighting Contract for Commonwealth Games meets “Disposal” test” (2018) IBFD p. 2

<sup>97</sup> Such as ownership or rent

<sup>98</sup> Comm. on Art. 5, paragraph 11

<sup>99</sup> See: Kees van Raad “Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties” in *Memorias de las 38 Jornadas Colombianas de Derecho Tributario* (2014), ICDT, p.427 and Jacques Sasseville and Arvid A. Skaar “General Report” in, *Is there a permanent establishment?* (2009) IFA pp.35

<sup>100</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, *Is there a permanent establishment?* Op. Cit., pp. 35

<sup>101</sup> Comm. on Art. 5, paragraph 12

<sup>102</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp. 25

<sup>103</sup> Federal Tax Court, decision of 4 June 2008, No. I R 30/07

“The installations used by the taxpayer at the airport only qualified as a fixed place of business if the taxpayer had them at his disposal permanently, and not just temporarily. For this to be the case it was not necessary that he owned or had rented them. It was sufficient that he had a legal position that could not be withdrawn at any time without his consent. But the mere possibility to use the facilities in the interest of another party or the mere factual use of the facilities was not sufficient, even if the activities were carried on recurrently or permanently”.

In the same sense, in India, the court<sup>104</sup> analyzed the “at the disposal of” element and noted<sup>105</sup>:

“There was nothing to indicate that whenever any employee of the assessee (foreign company) visited India, he could straightaway walk into the office of ECI (Indian company) and occupy a space or a table. Merely because ECI allowed the visiting employees to use certain facilities occasionally, it could not be said that the assessee had at its disposal, as matter of right, certain space which could be characterized as a fixed place of business in terms of article 5.1 of the Double Tax Treaty”.

The right to access and use the place does not have to be exclusive, in fact, many enterprises can have at their disposal the same place, and even, the place of business of an enterprise can be situated in the business facilities of another enterprise<sup>106</sup>. In this regard, the commentary<sup>107</sup> provides the following example:

“An employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former

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<sup>104</sup> Ericsson Radio Systems AB. vs Deputy Commissioner of Income Tax, case 815, Tax Treaty Case Law IBFD.

<sup>105</sup> O. Popa “At the disposal of – The way towards a broader concept” in Taxation of business profits in the 21<sup>st</sup> century (IBFD Publications online) p.13

<sup>106</sup> Comm. on Art. 5, paragraph 10

<sup>107</sup> Ibid paragraph 15

company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer”

Under any circumstances, it is recognized that when an enterprise has the control over the place of business, this is considered to be at its disposal<sup>108</sup>.

#### **D. “BUSINESS ACTIVITY” ELEMENT**

In order to constitute a PE, the place of business must serve a foreign taxpayer’s business activity as opposed to other income-generating activities<sup>109</sup>, thus, a PE cannot exist unless the foreign taxpayer is engaged in a business activity<sup>110</sup>, which does not need to be of a productive character.

The business activity needs to be as such under the domestic laws of the country that applies the treaty and under the treaty itself<sup>111</sup>, however, neither the DTTs nor the commentaries provide a definition of what is a business activity. Nonetheless, article 5(4) of the DTTs incorporates a list of certain activities that are specifically excluded, therefore, a permanent establishment is deemed not to exist where a place of business is used solely for activities that are listed in that paragraph. The common feature of the activities<sup>112</sup>, in the list provided by article 5(4) of the DTTs is that they are, in general, preparatory or auxiliary activities. The decisive criterion to know what is deemed to be an activity of preparatory or auxiliary character is whether or not the activity performed in the fixed place of business itself forms an essential and significant part of the activity of the enterprise as a whole<sup>113</sup>. In this regard, the Italian supreme court<sup>114</sup> held that storage and delivery activities were not an

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<sup>108</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, *Is there a permanent establishment?* Op. Cit., pp. 35

<sup>109</sup> Ibid. pp.42

<sup>110</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp.17

<sup>111</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, *Is there a permanent establishment?* Op. Cit., pp. 38

<sup>112</sup> Comm. on Art. 5, paragraph 10

<sup>113</sup> Ibid.

<sup>114</sup> Italy - Case 5649, 20 March 2015

essential and significant part of the activity of the enterprise as a whole, thus storage and delivery activities are of auxiliary and preparatory character.

Historically, there have been some differences between the OECD and UN models regarding the list of exceptions, for instance, UN does not include the word “delivery”, which reflects the view of that what a place used for that purpose should, if the other requirements are met, be a permanent establishment<sup>115</sup>, while in the case of OECD Model the word “delivery” is included.

That difference was the main one between the 2011 UN Model and 2014 OECD Model. However, 2017 OECD Model introduced some changes<sup>116</sup> following the Action 7 of BEPS Action plan in order to prevent the avoidance of PE status through the specific activity exemptions, since there were identified two issues:

- Some of the exceptions incorporated in paragraph 4 of Article 5 did not need to be preparatory or auxiliary activities, therefore enterprises could perform substantial business activities without constituting a PE.
- Enterprises were fragmenting a whole operating business into several small operations in order to argue that each party is merely engaged in preparatory or auxiliary activities<sup>117</sup>.

As a result, it was included a “preparatory or auxiliary” condition for all the subparagraphs of Article 5(4) as well as a new “anti-fragmentation rule”.

#### **i. “PREPARATORY OR AUXILIARY” CONDITION**

As mentioned previously, if an activity forms an essential and significant part of the activity of the enterprise as a whole, such activity cannot be considered as,

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<sup>115</sup> Comm-UN. on Art. 5, paragraph 17

<sup>116</sup> Although, it also represented a difference between UN model and OECD model, the Action 7 of BEPS Action plan was further introduced through 2017 UN Model

<sup>117</sup> OECD “Discussion draft on additional guidance on the attribution of profits to permanent establishments” (2016), pp. 3



regardless what the activity is, preparatory or auxiliary. For instance, article 5 (4) states:

“The term “permanent establishment” shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise”.

In this sense, a warehouse may not constitute a permanent establishment because the activities performed therein are normally of storage or delivery, however, if the warehouse constitutes a significant part of the overall business of the enterprise; in this regard, the commentary<sup>118</sup> provides an example:

“An enterprise of State “R” maintains in State “S” a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S.”

In this case, the exclusions of paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise’s sale/distribution business and do not have, therefore, a preparatory or auxiliary character<sup>119</sup>. The same reasoning is applicable to the other exceptions<sup>120</sup>.

## **ii. THE ANTI-FRAGMENTATION RULE**

According to this rule, which is incorporate within paragraph 4.1<sup>121</sup> of article 5, the exceptions provided by paragraph 4 do not apply to a place of business that would constitute a permanent establishment if the whole activities of an enterprise, or closely related enterprises, constitute complementary functions that are part of a

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<sup>118</sup> Comm. on Art. 5, paragraph 22

<sup>119</sup> Ibid.

<sup>120</sup> To see them go to [THE CURRENT PE PROVISIO IN THE DTTs](#)

<sup>121</sup> This paragraph was not incorporated in the other models

cohesive business operation<sup>122</sup> in the same country. However, paragraph 4.1 only applies when at least one of the following cases occurs:

1. When an enterprise, or closely related enterprises, has/have a PE in a country and the business activities carried on at that PE are part of a cohesive business operation carried on at another place of business of the enterprise or the closely related enterprises, such place of business must be considered as a PE even if the activities performed therein are of an auxiliary or preparatory character. In this regard, the commentary<sup>123</sup> provides an example

“RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyze the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S)”.

2. When the overall activity resulting from the combination of the activities carried on by an enterprise or closely related enterprises (either itself/themselves or through subsidiaries) in a same country, is not of a preparatory or auxiliary character even if each of the activities is separately considered of an auxiliary or preparatory character. The commentary<sup>124</sup> gives an example to illustrate how it works

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<sup>122</sup> Comm. on Art. 5, paragraph 79

<sup>123</sup> Ibid. paragraph 81

<sup>124</sup> Ibid.

“RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse. In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph a) thereof, applies to the warehouse”.

Through the implementation of this anti-fragmentation rule, it is expected that tax planning schemes, identified in the Base Erosion and Profit Shifting (BEPS) Project, that used to use to break a business activity into several little business activities in order to make them of an auxiliary or preparatory character, will be considerably reduced.

#### **E. “BUSINESS CONNECTION” ELEMENT**

According to the commentary<sup>125</sup> for a place of business to constitute a PE, the enterprise using it must carry on its business wholly or partly through such place, thus, a PE is triggered only if the business activity is actually performed “through” the fixed place of business<sup>126</sup>. The word “through” has led to understand that it means the same as “in” and “at”<sup>127</sup>.

It is not required that the entire core business is carried on through the place of business but that such place of business serves the business activity of the taxpayer.<sup>128</sup>

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<sup>125</sup> Ibid. paragraph 35

<sup>126</sup> Yariv Brauner “Commentary on Article 5 of the OECD Model” Op. Cit., pp. 23

<sup>127</sup> Jacques Sasseville and Arvid A. Skaar “General Report” in, Is there a permanent establishment? Op. Cit., pp. 43

<sup>128</sup> Ibid.

An enterprise can carry on its business within a place of business in different ways, either by the entrepreneur or persons who are in a paid-employment relationship with the enterprise that includes employees and other persons receiving instructions from the enterprise<sup>129</sup> even if those persons receive also instructions from a third part; an enterprise may also carry on its business by subcontractors, acting alone or together with employees of the enterprise, and even, through automatic equipment. Therefore, if a non-resident enterprise for example, that has at its disposal a fixed place of business, sends an employee to such place to do the enterprise's business activity, it is considered that the enterprise is carrying on its business through such place of business and accordingly a PE would be constituted.

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<sup>129</sup> Comm. on Art. 5, paragraph 39

### **III. PE BASIC RULE IN THE COLOMBIAN TAX LEGAL SYSTEM**

Although the current concept of PE was elaborated since 1963 through that year OECD Draft Convention for the avoidance of double taxation respect to taxes on Estates and Inheritances, Colombia did not have within its domestic laws the concept of PE until 2012, when the Colombia's Congress incorporated it.

In order to understand the reason why Colombia took so long to include the PE clause, it is necessary to observe the social, political and economic conditions of the country during the previous years.

#### **A. ORIGIN AND HISTORICAL EVOLUTION OF PE IN COLOMBIA**

After the second war, the UN through its commission for Latin America and the Caribbean ECLAC<sup>130</sup>, enforced Latin America to apply the economic system of Import substitution industrialization (ISI)<sup>131</sup> which made this region to close their external commercial relationships with other countries and focus on the internal market, thus, no one was thinking about signing DTTs.

However, in the late eighties, there was a boom of the economic thought of Chicago School which advised countries to open their commercial relationships with other countries. Such current of outlook was taken by the government of President CESAR GAVIRIA (1990 – 1994) who decided to open the Colombia's economy to the rest of the world to -among other reasons- increase the foreign direct investment (FDI). Nonetheless, during this time no DTTs was signed by Colombia because there was

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<sup>130</sup> Its Spanish acronym CEPAL, it is one of the five regional commissions of the United Nations. It was founded with the purpose of contributing to the economic development of Latin America, coordinating actions directed towards this end, and reinforcing economic ties among countries and with other nations of the world. The promotion of the region's social development was later included among its primary objectives.

<sup>131</sup> it is an economic policy which suggest replacing foreign imports with domestic production. It is based on the premise that a country should attempt to reduce its foreign dependency through the local production of industrialized product

fear that signing DTTs was only going to help the increase of FDI in developed countries but not in developing countries such as Colombia<sup>132</sup>.

In the late nineties, investors were increasingly complaining about the Colombian tax system because there were not enough mechanisms to prevent international double taxation<sup>133</sup>; as an answer, the government of President ALVARO URIBE (2002 – 2010) consolidated the economic and commercial liberalization of Colombia, and eventually, in 2005 Colombia signed, its first DTT, with Spain<sup>134</sup>.

Although the DTT signed with Spain, followed by the below mentioned DTTs, was a huge step of Colombia regarding globalization, Colombian domestic laws were not ready to apply such DTTs properly.

<b>Double Tax Treaties signed by Colombia</b>			
<b>Signed with</b>	<b>Singed in</b>	<b>Into force since</b>	<b>Approving law</b>
Spain	2005	2007	Law 1082 de 2006
Chile	2007	2009	Law 1261 de 2008
Switzerland	2007	2012	Law 1344 de 2009
Canada	2008	2012	Law 1459 de 2011
Mexico	2009	2013	Law 1568 de 2012
Portugal	2010	2014	Law 1692 de 2013
South Korea	2010	2016	Law 1667 de 2013
India	2011	2014	Law 1668 del 2013
Czech Republic	2012	2015	Law 1690 de 2013
France	2015	PFA <sup>135</sup>	PFA

<sup>132</sup> Eric Neumayer “Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?” (2007) Journal of Development Studies.

<sup>133</sup> Juan David Rodríguez Ríos et al., “El comercio como plataforma de la política exterior colombiana en la administración de Juan Manuel Santos, en Colombia Internacional” No 76, Julio a diciembre de 2012

<sup>134</sup> This DTT was approved in Colombia through the law 1082 of 2006 and was in force way back in 2007.

<sup>135</sup> Pending for Approval

UK	2016	PFA	PFA
Arab Emirates	2017	PFA	PFA
Italy	2018	PFA	PFA

One of the difficulties was the lack of PE proviso in its internal tax legal system<sup>136</sup>, which led to a debate between scholars, some considered that article 5<sup>137</sup> of the double tax treaties signed by Colombia<sup>138</sup> was not applicable because the purpose of the DTTs is to restrict existing countries taxing rights<sup>139</sup> and thus Colombia did not have any right to tax PEs because such figure did not exist. Thus, there was no taxing right to restrict. On the other hand, it was said that since Colombia introduced the DTTs through laws, according to article 150 numeral 16 of the Colombian constitution, it must be understood that such acts incorporated the PE figure into the Colombian tax legal system and therefore, the DTTs could be applicable.

Regardless what position was taken about the applicability of article 5 of the DTTs, it was agreed that it was necessary to include the PE proviso in Colombia in order to provide legal certainty concerning the taxation of foreign natural people without residence in Colombia, as well as, of foreign companies and entities that carry out activities permanently in the country without having established a branch within it<sup>140</sup>. Thus, it was advised to include a concept of PE which follows the concept of the DTTs, as well as, it was suggested to clarify the way in which the income obtained through the permanent establishment should be attributed for tax purposes.

As a result, the Congress of Colombia, through Law 1607 of 2012, which modified the Colombian Tax Code (CTC), eventually included the concept of PE.

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<sup>136</sup> The closest figure to PE in Colombia was “the branch”, however, it did not cover the same scope of PE and it did not have the same target, thus, it could not be considered that such figure could replace the PE clause. See: Cesar Montañó “Derecho fiscal internacional. Establecimiento Permanente” (2004) Temis, pp 90- 94

<sup>137</sup> Regarding PE definition of article 5 (1), Colombia followed the same wording than the DTTs

<sup>138</sup> At the time, the DTTs signed with Spain, Chile, Switzerland and Canada were operating.

<sup>139</sup> Michael Lang “The interpretation of double taxation conventions in Introduction to the Law of Double Taxation Convention” (Second Revised Edition) (2013) IBFD, pp 1

<sup>140</sup> Exposition of reasons of the Law 1607 of 2012

## B. CONCEPT OF PE IN COLOMBIA AND ITS ISSUES

Due to the recommendations provided by the Superior Council of Foreign Trade of Colombia (SCFT)<sup>141</sup> of adapting the internal regulations to the OECD standards, the Law 1607 of 2012 incorporated, within article 20-1 of CTC, a PE basic rule concept following almost the same wording and structure as the OECD Model's at that time (2010 OECD Model), as it can be observed below.

“Article 20-1: Permanent Establishment <sup>142</sup>

The term “permanent establishment” means a fixed place of business located in the country, through which a foreign enterprise, being a corporation or any other foreign entity, or a non-resident individual, wholly or partly carries on its business activity”

Then the article sets up a list of examples that will be specially regarded as PE (positive list) in the same sense as the Models

“... the concept of “permanent establishment” includes, among others, branches, agencies, offices, factories, workshops, mines, quarries, oil or gas wells and any other place of extraction and exploitation of natural resources.”

The article ends, regarding PE basic rule, by saying that there is no PE when the activity, carried on through it, is of an exclusively auxiliary or preparatory character (negative list).

“There is no permanent establishment for a foreign company that has a place of business in the country when the activity carried out through such place is exclusively auxiliary or preparatory, such as<sup>143</sup>:

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<sup>141</sup> Work session #81, 27 of March 2007

<sup>142</sup> This translation is of my own because there is no an official English translation of such proviso

<sup>143</sup> This list is incorporated within article 3 of the decree 3026 of 2013 of 2013



- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- e) the maintenance of a fixed place of business exclusively for the development of promotional and marketing activities, including those developed by representation offices of foreign entities, as long as these are not capable of contractually bind their principals in the businesses or contracts they are promoting;
- f) the maintenance of a fixed place of business solely for any combination of activities previously mentioned, provided that such combination has an auxiliary or preparatory character.

In any case, the activities or any combination of them, that constitute essential, significant or principal part of the foreign enterprise's business activity or combination of activities, must not be considered as preparatory or auxiliary".

Although the Colombia's PE concept and the Models' are quite similar, there are some differences with the current OECD concept (2017 OECD Model), due to the fact that the Colombian concept is based on 2010 Model and, as it was analyzed in the document, 2017 Model introduced some changes following the BEPS recommendations, thus, Colombia is outdated in that regard. The main difference is regarding the anti-fragmentation rule, which is not incorporated in the negative list of article 20-1 of the CTC, therefore, those tax planning schemes, identified in the BEPS Project, that break a business activity into several little business activities in order to make them of an auxiliary or preparatory character, are hard to tackle under the Colombian tax system. For instance, there would not be a PE in Colombia in the

case that a group of closely related foreign enterprises come to Colombia and each of them carries on an activity considered of an auxiliary or preparatory character, but the overall activity resulting from the combination of the activities carried on by them is not of a preparatory or auxiliary character.

The differences mentioned above are regarding the wording of the definition, however, there are other differences regarding the way such definition must be interpreted because, as the Model's definition of PE is complemented by the commentaries, the Colombian's is complemented by the decree 3026 of 2013<sup>144</sup> which regulates the PE concept, and these ways to complement the concept of PE differ from each other. The main difference is that, even though article 2 of the decree 3026 of 2013 states the same elements of a PE than the Models, it does not provide a guidance of how those elements must be understood; for instance, article 2 of the decree 3026 of 2013 established that to consider a place of business as fixed (fixed element), it must have "a certain degree of permanence" (tempus test), and then, it does not say anything regarding what "a certain degree of permanence" should be understood like, which affects legal certainty among investors<sup>145</sup>. Whereas, the commentaries to the models provide some criteria in order to clarify when a place of business could be fixed in term of permanence, such as the 6-month timeframe threshold.

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<sup>144</sup> This decree was incorporated into unified decree 1625 of 2016

<sup>145</sup> Kees van Raad "Permanent Establishment as threshold for Cross-Border Business Income Taxation – Issues stemming from the simultaneous use of the notion PE in the domestic tax law of Colombia and in its tax treaties" Op. Cit., pp. 460.

## CONCLUSIONS

Although the basic concept of permanent establishment, which means “a fixed place of business in which the business of the deceased was wholly or partly carried out”, seems to be a simple concept, it is not because its meaning involves several elements, which also contain several characteristics making the PE concept a complex one.

The commentaries of the models try to make an effort in order to clarify what the elements of the PE concept are and how they work, however, sometimes the commentaries are not enough to understand properly the elements of PE concept, which has led to discussions on the actual way that some elements must be understood, as it happens with the element of having the disposal of the place of business, whose development has been mainly carried out by the courts worldwide.

There is not a certain way to meet each of the elements of the PE concept, for instance, regarding the tempus test, a place of business, to be considered as fixed, needs to last at least 6 months unless the nature of the activities carried out in such place is of a short period, thus, the time must be analyzed case by case.

The fact that there are different ways to meet the elements, under OECD and UN Models, does not mean a lack of legal certainty because the commentaries as well as the international courts worldwide provide enough criteria to apply them, and according to the Vienna Convention, these are source of interpretation of the international treaties. On the other hand, the PE Colombian basic concept elements do represent a lack of legal certainty because there is not in Colombia any development similar to the commentaries that can be used to understand how the elements work, thus, I consider the government should include a decree through which the elements of the Colombian PE concept can be developed.

The Colombian government could even go further than what is stated in the commentaries to OECD and UN Models, because as it was explained, the current commentaries' understanding of PE concept does not respond to the current reality of economic worldwide due to the evolution of business models in general, which has caused that some requirements become obsolete such as the requirement of having a physical presence.

Moreover, since the intent of Colombia is following the OECD standards, it is also necessary to change the current definition of PE in the CTC, because such definition is based on the 2010 OECD Model, and in 2017, the OECD introduced some changes, such as the anti-fragmentation rule, which are essential in the battle against the tax avoidance. For this purpose, the congress should make a legislative reform including the new changes of the OECD's PE concept.

Undoubtedly, there are going to be always enterprises trying to avoid meeting the elements of the PE in order to not pay taxes in the countries where they carry out their business activities, that is why it is important to have a strong legislation that can tackle different tax avoidance strategies. On the other hand, it is important to have a clear and developed normativity that provides legal certainty to foreign investors which allow them to know in which cases they will be considered to have a PE, otherwise they will not be encouraged to invest.

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